



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date:

[REDACTED]

Contact Person:

[REDACTED]

Identification Number:

[REDACTED]

Contact Number:

[REDACTED]

[REDACTED]

Employer Identification Number:

[REDACTED]

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

You were incorporated on [REDACTED], pursuant to the [REDACTED] under the name [REDACTED]. These original articles state that you are a "public benefit corporation", but no purposes are stated, and otherwise this document does not satisfy the organizational test under section 501(c)(3) of the Code, except for a satisfactory dissolution provision. On [REDACTED]

Following recommendations made by this office in our development and advisory letter dated [REDACTED], you filed Articles of Amendment with the [REDACTED] on [REDACTED]. These amended articles set forth charitable and other exempt purposes under Code section 501(c)(3), and state appropriate limitations on the scope of your activities. They also prohibit the inurement of your net earnings to the benefit of any private person who is a member, trustee, or officer, or serves in such capacity with your sole member, [REDACTED] except that you are authorized and empowered to pay reasonable compensation for services rendered. [REDACTED] is also designated as the recipient of your remaining assets upon dissolution, as long as it remains tax exempt under section 501(c)(3).

[REDACTED] as your sole member and describes it as [REDACTED]. Your [REDACTED] is to provide assistance [REDACTED] in order to help further its mission.

[REDACTED]

[REDACTED] states that your Board of Directors shall consist of [REDACTED] or such greater or lesser number as your sole member, [REDACTED] shall determine. The [REDACTED] All Directors are [REDACTED]

In response to [REDACTED], exemption application, you reiterate that your [REDACTED] in order to help further its global and local mission.

[REDACTED]

You go on to state that [REDACTED] success gives it the talent pool and experience needed to help [REDACTED] that are currently experiencing operating difficulties. [REDACTED] has decided to extend this service through the creation of your own organization as a wholly-owned subsidiary. All cash generated by your activities will be distributed to [REDACTED] in furtherance of its exempt purposes.

You will provide training and assist in strengthening the [REDACTED] performance by providing: (a) training materials for operations; (b) evaluations of daily operating procedures; (c) training of accounting personnel and assistance with interpreting financial data; (d) supervisory training and goal establishment through conferences, and (e) onsite training for volunteers and professionals.

You will also provide assistance to the [REDACTED] through software selection and training and the adoption of policies and procedures that have proven successful with other members. You will provide training for an executive search, career development, and professional support.

You will assist in the development of local donors and public involvement. This will be done through the implementation of programs designed to strengthen local fund-raising efforts through corporate partnerships. You will also assist with planning and training for local solicitations and endowed gifts. You will provide training in matching volunteers and volunteer opportunities with [REDACTED]. Finally, you will provide assistance in writing grant applications and grant development.

The efforts to strengthen local [REDACTED] performance will be carried out by executives and managers of [REDACTED] along with an outside consulting company under contract. Executives and managers will contribute their services at no charge to you. All services are to be performed at the local [REDACTED].

[REDACTED]

[REDACTED]

[REDACTED]

In Part IV of Form 1023, you have furnished estimated budgets for your taxable years ending [REDACTED] all revenue is placed on [REDACTED] An attached statement lists this income as [REDACTED] and in the following amounts for the noted years: [REDACTED] All expenses for the years in question are placed on [REDACTED] and are designated [REDACTED] in an attached statement. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] Trainer shall also advise and train executives on oversight of all accounting functions of [REDACTED] and financial record keeping. Trainer shall advise on maintaining a Management Information Services ("MIS") System for the gathering, synthesis, analysis, storage, and retrieval of data relevant to the operations of [REDACTED]. Trainer will also make recommendations concerning needed insurance and legal services. In addition, Trainer shall furnish all policy manuals required for the operations of [REDACTED].

[REDACTED], entitled [REDACTED] provides that, within [REDACTED] days of the Effective Date of the Agreement, Trainer shall arrange for a loan in the amount of [REDACTED]. Such monies shall be drawn upon as needed over the first [REDACTED] as determined by Trainer. The note will bear interest at the rate of 10% per annum, with an annual payment of principal in the amount of [REDACTED] plus interest, at the end of year one. The loan will then be paid off over the next two years (principal plus interest). The note shall be secured by a lien on all personal property.

[REDACTED] provides, in part, as follows:

[REDACTED] shall pay Trainer a training fee for the services of [REDACTED] per year payable in equal monthly installments plus [REDACTED] % of the total gross proceeds or revenue received by [REDACTED] from all sources including donations and gifts, but excluding loans, government contract revenue or payments (the [REDACTED] It is understood that such

training fee may be deferred by [REDACTED]
of the initial year as [REDACTED] in working through its
current cash flow difficulties.

In addition to the foregoing compensation, Trainer shall be entitled to a refund of all of its out-of-pocket costs incurred in performance of its duties and obligations under this Agreement to include without limitation (a) all reasonable costs of travel including plane fare, taxi, car rental, hotel/motel costs, etc., and (b) all outside costs incurred in performance of obligations to include legal, accounting, budgeting, third party consulting, et al.

[REDACTED] sets forth the rules concerning termination of the Agreement by either party, and provides [REDACTED] as follows:

Termination Fee. In the event this Agreement is terminated for any reason other than the intentional malfeasance, fraud, illegal acts or gross neglect of Trainer ("Just Cause"), Trainer shall be entitled to a termination payment of [REDACTED] Dollars plus [REDACTED] percent (%) of the Adjusted Gross Revenue of [REDACTED] until the [REDACTED] year from the Effective Date. At the end of the initial [REDACTED] year term if [REDACTED] elects not to extend this agreement, then the above referenced four (4%) of Adjusted Gross Receipts fee shall be reduced to two percent (2%) and Trainer shall be available for periodic consulting and shall fully cooperate in the transition from Trainer's oversight and review.

The administrative file also contains a copy of a Master Agreement between [REDACTED]. The Agreement recites [REDACTED] of an effective donated goods business which creates jobs for targeted populations and that other [REDACTED] have sought [REDACTED] in developing their donated goods business through training. It then states that [REDACTED] "needs a third party agent to respond to and manage other [REDACTED] for donated goods services outside its territory."

[REDACTED], entitled [REDACTED], recites that inasmuch as two (2) of the principals of [REDACTED] that any business opportunity presented to [REDACTED] that involves [REDACTED] assigned territory or a potential [REDACTED] assigned territory shall first be presented to [REDACTED] will not enter into any arrangement with a third party [REDACTED] without the consent of [REDACTED] is required to present such opportunities to [REDACTED] in good faith with a full and fair disclosure of all relevant facts.

[REDACTED]

[REDACTED] entitled Management, states, in part, that, "if [REDACTED] wishes to pursue an opportunity involving the third party [REDACTED] will be reimbursed by the third party [REDACTED] or third party [REDACTED] territory for its out-of-pocket expenses incurred in putting the opportunity together. It is additionally envisioned that [REDACTED] will be utilized on such opportunities to provide management and training services to such third parties on behalf of [REDACTED] per a separate agreement..."

[REDACTED] entitled Conflict of Interest/Salary Impact, provides as follows:

Principals of [REDACTED]

[REDACTED] To the extent that [REDACTED] responsibilities detract from such parties involvement with [REDACTED], such executive compensation may be impacted and reduced. In that connection books and records of [REDACTED] will be available at all times including the distributions to the principals either through compensation or dividends.

[REDACTED] states as follows:

Capital Contribution. It is understood that in certain circumstances [REDACTED] may be making loans or capital contributions to various deals or transactions with such third party [REDACTED]. In that connection it is contemplated that the specific agreement between [REDACTED] with regard to such shall provide that no payment shall be made to [REDACTED] until : (a) such loans or capital contributions are repaid (or are current in their payments) to [REDACTED] and, (b) the actual cash is received by [REDACTED]

[REDACTED] provides:

Compensation. It is understood that the majority of benefits under the third party arrangements with third party [REDACTED] shall be in and/or to [REDACTED]. At the time of execution of this Agreement it is generally envisioned that [REDACTED] will receive approximately forty percent (40%) of the net proceeds which amount may be higher or lower depending upon whether [REDACTED] must loan or contribute capital to such arrangements.

[REDACTED] the term of the Agreement shall be year to year, subject to either party's right to terminate upon 60 days written notice.

[REDACTED]

The administrative file also contains copies of two [REDACTED]. The language is identical in the two Agreements, except that one involves [REDACTED]

The second Specific Service Agreement provides that [REDACTED] has requested training and management services. [REDACTED] is prepared to provide such assistance with the utilization and assistance of [REDACTED]. [REDACTED] states that, "The terms of the Master Agreement between these parties is ratified and confirmed and incorporated herein."

[REDACTED] provide, respectively, as follows:

3. Training Services Provided. [REDACTED] agrees to provide direction and assistance to [REDACTED] in fulfilling its responsibilities and duties under the third party agreement with [REDACTED] and shall be responsible for ensuring compliance with [REDACTED] obligations under such agreement. Such duties shall include: the development of training programs and training related to [REDACTED]

4. Compensation. [REDACTED] should be compensated as follows: For services provided [REDACTED] shall receive forty percent (40%) of the fees paid by [REDACTED] (or any subsidiary thereof); as fees are paid; and consistent with the terms and conditions of the Master Agreement.

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated "exclusively" for religious, charitable, educational, or other specified exempt purposes, "no part of the earnings of which inures to the benefit of any private shareholder or individual", and which does not engage in proscribed lobbying and political activities.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order to qualify for exemption under Code section 501(c)(3), an organization must be both organized and operated exclusively for one or more exempt purposes. Failure to meet either the organizational or operational test will disqualify an organization from exemption under section 501(c)(3).

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for a section 501(c)(3) exempt purpose unless it serves a public rather than a private interest. Thus, it is necessary that the organization establish that it is not operated for the benefit of private individuals. An organization will not satisfy the operational test if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. See section 1.501(c)(3)-1(c)(2). Under section 1.501(a)-1(c), the term "private

shareholders or individuals" refers to persons having a personal and private interest in the activities of the organization.

In general, an organization which applies for recognition has the burden of proving that it clearly meets all the requirements of the particular Code section under which it has applied. See Kenner v. Commissioner, 318 F. 2d 632, 635 (7th Cir. 1963), and Cleveland Chiropractic College v. Commissioner, 312 F. 2d 203, 206 8th Cir. 1963). This includes proof that no part of an organization's assets or net earnings inures to the benefit of any private individuals. Even a small amount of private inurement is fatal to exemption. See Spokane Motorcycle Club v. U.S., 222 F. Supp. 151 (E.D. Wash. 1963), wherein the Federal District Court held that net profits inures to private individuals where refreshments, goods, and services amounting to \$825 (representing some 8% of gross revenues) were furnished to members.

There is no prohibition against an exempt charity dealing with its founders, members, or officers in carrying out its exempt purposes and in seeing to the conduct of its economic affairs. However, any transaction between an organization and a private individual in which the individual appears to receive a disproportionate share of the benefits of the exchange relative to the charity served presents an inurement issue. Such transactions may include assignments of income, compensation arrangements, sales or exchanges of property, commissions, rental arrangements, gifts with retained interests, and contracts to provide goods or services to the organization.

Rev. Rul. 69-383, 1969-2 C.B. 113, provides an example of a possible inurement situation which did not jeopardize the organization's exempt status. The revenue ruling depicts a tax exempt hospital which entered into a contract with a radiologist after arm's length negotiations. The contract provided for the radiologist to be compensated through a percentage of the gross receipts of the radiology department. Rev. Rul. 69-383 concludes that the agreement did not jeopardize the hospital's tax exemption under section 501(c)(3) for the following reasons: (1) the agreement was negotiated on an arm's length basis; (2) the radiologist did not control the hospital; (3) the amount received under the contract was reasonable in terms of the responsibilities and duties assumed; and (4) the amount received under the contract was not excessive when compared to the amounts received by other radiologists in comparable circumstances.

A different outcome is found in the case of John Marshall Law School and John Marshall University v. United States, 81-2 USTC 9514 (Ct. Cl. 1981). In this case, a private, unaccredited law school and college were operated by two brothers and members of their families. The Service revoked the exemption of both organizations on the ground that part of the net earnings of the organizations inured to the benefit of private shareholders or individuals. The organizations then filed suit in the Court of Claims.

The Court opened its discussion of the case by noting that,

(t)he term "net earnings" ... has been construed to permit an organization to incur ordinary and necessary expenses in the course of its operations without losing its tax exempt status. ... The issue, therefore, is whether

[REDACTED]

or not the expenditures JMLS paid to or on behalf of the Fenster family were ordinary and necessary to JMLS operations.

The Court then detailed with particularity each of a series of interest-free, unsecured loans used by the controlling brothers to purchase a home and furnish it, the granting of noncompetitive scholarships to their children, and payment of nonbusiness related expenses for travel, health spa membership, and entertainment. Accordingly, the Court upheld the Service's revocation of its tax exempt status.

Other case examples of inurement include payment of excessive rent, Texas Trade School v. Commissioner, 30 T.C. 642, aff'd, 272 F. 2d 168 (5th Cir. 1959); receipt of less than fair market value in sales or exchanges of property, Sonora Community Hospital v. Commissioner, 46 T.C. 519 (1966); and inadequately secured loans, Lowry Hospital Association v. Commissioner, 66 T.C. 850 (1976).

A common factual thread running through the cases where inurement has been found is that the individual stands in a relationship with the organization which offers him the opportunity to make use of the organization's income or assets for personal gain. This leads to the conclusion that a finding of inurement is usually limited to a transaction involving insiders.

Section 1.501(c)(3)-1(e) of the regulations provides that an organization may meet the requirements of Code section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose(s) and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3).

Rev. Rul. 71-529, 1971-2 C.B. 234, describes a nonprofit organization formed to aid certain section 501(c)(3) organizations by assisting them to manage more effectively their endowment or investment funds, and by obtaining contributions to cover all or part of the costs to manage such funds or to provide supplemental income or capital to be used to further their exempt purposes. The organization receives capital from the participating exempt organizations, which capital is then placed in one or more common funds in the custody of various banks. These common funds are controlled and managed by the organization.

Membership in the organization is restricted to colleges and universities which are tax exempt under section 501(c)(3). Its board of directors is composed of representatives of the member organizations.

Most of the organization's operating expenses are paid for by grants from independent charitable organizations. The member organizations pay only a nominal fee, representing less than 15% of the total operational costs.

Rev. Rul. 71-529 cites Code section 501(c)(3) and then reasons as follows:

By providing the services described above to its members, the organization is performing an essential function for charitable organizations. By performing this function for the organizations for a charge that is substantially below cost, the organization is performing a charitable activity within the meaning of section 501(c)(3) of the Code.

Held, the organization qualifies for exemption under section 501(c)(3) of the Code.

The revenue ruling also distinguishes the facts set forth above from those presented in Rev. Rul. 69-528, 1969-2 C.B. 127, on the following basis: "In Revenue Ruling 69-528 the facts indicated that the organization was primarily engaged in carrying on an investment management business for charitable organizations on a fee basis free from control of the participants."

Rev. Rul. 72-369, 1972-2 C.B. 245, describes an organization formed to provide managerial and consulting services for nonprofit organizations which are tax exempt under section 501(c)(3) in order to improve the administration of their charitable programs. The organization provides these services to unrelated nonprofit organizations on a cost basis. The services consist of writing job descriptions and training manuals, recruiting personnel, constructing organizational charts, and advising organizations on specific methods of operation. The organization derives all its support from the fees for its managerial and consulting services.

Rev. Rul. 72-369 observes that an organization is not tax exempt merely because its operations are not conducted for the purpose of producing a profit. In order to satisfy the operational test under section 501(c)(3), an organization's resources must be devoted to exclusively charitable purposes within the meaning of section 501(c)(3) and underlying regulations. The revenue ruling then concludes that,

Providing managerial and consulting services on a regular basis for a fee is trade or business ordinarily carried on for profit. The fact that the services in this case are provided at cost and solely for exempt organizations is not sufficient to characterize this activity as charitable within the meaning of section 501(c)(3) of the Code. Furnishing the services at cost lacks the donative element necessary to establish this activity as charitable.

Held, the organization depicted does not qualify for tax exemption under section 501(c)(3) of the Code.

Rev. Rul. 72-369 also distinguishes this case "from the situation where an organization controlled by a group of exempt organizations and providing investment management services for a charge substantially less than cost solely to that group qualifies for exemption from federal income tax under section 501(c)(3) of the Code. See Rev. Rul. 71-529, 1971-2 C.B. 234."

[REDACTED]

With respect to your own application, the [REDACTED] may provide management and training services to various third parties on behalf of [REDACTED]. In point of fact, the evidence in the administrative file leads us to conclude that you are the subsidiary which both parties have in mind. The Master Agreement is dated [REDACTED]. So are two Specific Service Agreements, involving two identified [REDACTED].

The Master Agreement provides that, [REDACTED] depending upon whether [REDACTED] must loan or contribute capital to such arrangements."

[REDACTED] shall receive 40% of the fees paid by [REDACTED] and consistent with the terms and conditions of the Master Agreement. Furthermore, the terms of the Master Agreement are expressly incorporated into the Specific Service Agreements.

Prior to the execution of the above agreements, you had entered into a Training and Development Services Agreement with the [REDACTED] to provide various training, management, and accounting services, as detailed above. This contract calls for you ("Trainer") to receive a service fee of [REDACTED] per annum plus [REDACTED]% of the total gross proceeds or revenue received by [REDACTED], including donations and gifts, but excluding loans and government contract revenue. You are entitled to reimbursement for various out-of-pocket expenses. The contract also sets forth substantial termination fees should the [REDACTED] not extend the contract within specified periods.

The Specific Service Agreement between [REDACTED] designated as the party to be aided, appears designed to help implement the contract discussed just above.

Two of the three principals of [REDACTED] as previously indicated, is your sole member and selects all the members of your governing board. [REDACTED] also serves as your President, Secretary, and Treasurer.

[REDACTED] stand to reap substantial financial gain from the Master Agreement and the two Specific Service Agreements discussed above. The Master Agreement calls for [REDACTED] to receive 40% of net proceeds (with some possible variance). The evidence in the administrative file indicates that you are the subsidiary organization mentioned in these contracts.

In light of the control that [REDACTED] are able to exert over your operations, we believe that the contracts noted above should be construed as resulting in the inurement of your net earnings to the benefit of "private shareholders or individuals" within the meaning of Code section 501(c)(3) and section 1.501(c)(3)-1(c)(2) of the regulations. Unlike the situation in Rev. Rul. 69-383, discussed above, we have no satisfactory evidence that the fees to

be paid to [REDACTED] were negotiated at arm's length. Nor do we have any indication that any entity other than [REDACTED] was considered for the service contracts in question. Further, there is no evidence that the fees to be paid to [REDACTED] may be considered fair market value.

There is an additional ground for concluding that you do not qualify for exemption under section 510(c)(3) of the Code. The training, management, and accounting services that you will provide to various [REDACTED] for a negotiated fee may be considered a trade or business ordinarily carried on for profit. The fact that these services will be provided to tax exempt organizations does not of itself make these services "charitable" within the meaning of section 501(c)(3). Furthermore, there is no indication whatsoever that the services in question will be provided at or below cost. The holding in Rev. Rul. 72-369, cited above, is fully applicable to your situation. See also section 1.501(c)(3)-1(e) of the regulations. You do not come within the purview of Rev. Rul. 71-529, also cited above, because the organization depicted therein was controlled by tax exempt colleges and universities and the investment management services which the organization provided to them were furnished for a fee which was substantially below cost. The requisite donative element is not present in your application.

Based on the foregoing, we conclude that you do not meet the operational test under Code section 501(c)(3). In order to qualify for exemption, an organization must satisfy both the organizational test and the operational test. See section 1.501(c)(3)-1(a)(1) of the regulations.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling

[REDACTED]

877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

[REDACTED]

You may wish to FAX your response to us by using the following number: [REDACTED]. Please make any FAX communication to the attention of [REDACTED].

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

[REDACTED]